Supreme Court, U.S.
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No. 99-1675

IN THE

Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

HAROLD D. FARLEY, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the Third Circuit is correct in its finding that the plain meaning of the Internal Revenue Code provides that cancellation of indebtedness income of a Subchapter S corporation flows through to its shareholders thereby increasing the shareholder's tax basis in the stock, notwithstanding that the Subchapter S Corporation is insolvent and the cancellation of indebtedness income exempt from tax.

2. Whether superseding regulations, which moot the issues presented, render granting of certiorari unwarranted in this case.

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26 U.S.C. § 1366 .....3, 4, 6

26 U.S.C. § 1367 ..... 3, 4

Other Authority:

Treas. Reg. § 1.1366-1(a)(2)(viii), 64 Fed. Reg. 71641 (Dec. 22, 1999) 9

STATEMENT OF THE CASE

This appeal pertains to the tax consequences relating to Respondents' inclusion of cancellation of indebtedness income in the tax basis of their stock of a Subchapter S Corporation. Based upon the increase in tax basis the Respondents amended their tax returns and obtained a refund. The Government instituted this action in District Court to recover the refund.

Since the outset of this litigation, the parties have agreed that there are no disputes over material issues of fact and that the sole question is one of statutory construction.

In 1986, through an investment of $200,000, the Respondents received 50% of the stock of two S corporations, SCI Acquisition, Inc. ("SCI") and CCI Camping Corp. ("CCI") (collectively, the "Farley S Corporations"). During 1986 and 1987, the Farley S Corporations each incurred losses, which losses, for tax purposes, passed through to the Respondents. As a result of these losses, by the end of tax year 1987, the Respondents had a zero basis in each of the Farley S Corporations.

From 1987 through 1992, the Farley S Corporations each continued to incur losses, which, due to their lack of basis, the Respondents reported as suspended losses on their tax return (the "Suspended Losses").

During 1992, the Farley S Corporations ceased operating due to their continued operating losses. As a result, in 1993, the Farley S Corporations' secured creditors foreclosed on the assets of these businesses. All debt not satisfied by the sale of assets was forgiven (the "Debt Forgiveness"). At the

time of the Debt Forgiveness, and thereafter, the Farley S Corporations were insolvent. The Debt Forgiveness resulted in cancellation of indebtedness income to the Farley S Corporations (the "COD Income"). However, due to the Farley S Corporations' insolvency, the COD Income was exempt from taxation.

A. The Historical Tax Returns

On or about April 15, 1990, the Respondents filed their income tax return for tax year 1989 (the "1989 Return"). The 1989 Return indicated a tax liability of $67,507, which liability was paid by the Respondents.

On or about April 15, 1991, the Respondents filed their income tax return for tax year 1990 (the "1990 Return"). The 1990 Return indicated a tax liability of $112,553, which liability was paid by the Respondents.

On or about April 15, 1993, the Respondents filed their income tax return for tax year 1992 (the "1992 Return"). The 1992 Return indicated a tax liability of $42,936, which liability was paid by the Respondents.

On or about April 15, 1994, the Respondents filed their income tax return for tax year 1993 (the "1993 Return"). The 1993 Return indicated a tax liability of $44,748, which liability was paid by the Respondents.

On or about October 11, 1996, the Respondents filed their income tax return for tax year 1995 (the "1995 Return"). The 1995 Return indicated a tax liability of $0.

B. The Claim For Refunds

The Respondents filed amended tax returns (the "Amended Returns") for the years 1989, 1990, 1992, and 1993 (collectively, the "Relevant Tax Years"). As part of the Amended Returns, the Respondents made claims for refunds, and received refunds, for the Relevant Tax Years (the "Refund Claims") as follows: 1989 — $67,507; 1990 — $55,387 & $9,135 (two amended returns were filed); 1992 — $42,936; and 1993 — $44,748. (Appendix 30)

The Amended Returns were based upon the Farleys' increase in their tax basis relative to their investment in the Farley S Corporations. Through the increase in tax basis, the Farleys' were able to utilize the Suspended Losses, which had been unused in the Relevant Tax Years, resulting in a reduction of tax liability for each of the Relevant Tax Years.

In addition, through the same increase in basis, the Respondents were able to take losses in tax year 1995.

Thereafter, the IRS commenced this lawsuit seeking recovery of the refunds.

C. The Decision of The Third Circuit

The court of appeals held that the plain language of the statutory text of Subchapter S provides that an S corporation shareholder's basis is increased by all items of income, including cancellation of indebtedness income. 26 U.S.C. §§ 1366 and 1367. The court of appeals rejected the government's contention that the exclusion of an insolvent taxpayer's cancellation of indebtedness from income, 26 U.S.C. § 108(a)(1)(B), precludes that cancellation of indebtedness income from increasing the shareholder's basis.

The court of appeals' analysis of the relevant statutes went well beyond the single subsection of 26 U.S.C. § 108 upon which the Government now focuses. The court of appeals found that when read as a whole, the plain language of § 108, coupled with the Subchapter S provisions of §§ 1366 and 1367, requires the pass through of all items of income, including cancellation of indebtedness income, in the year of the income. Then, the tax attribute reduction associated with the insolvent taxpayer's exclusion of cancellation of indebtedness income takes place in the year following the discharge of indebtedness.

> The language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year *following* the year of the discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straight-forward. Discharge of indebtedness income, considered income under section 61(a)(12), is excluded from gross income pursuant to section 108(a)(1)(B) if, as in this case, the S Corporation is insolvent. This solvency determination is made at the corporate level rather than the individual shareholder level pursuant to section 108(d)(7)(A). Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1266(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholders' S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses

> previously suspended because the *corporation's* stock lacked adequate basis. Finally, the tax attribute reduction required by section 108(b) takes place on the first day of the tax year following the year of the discharge, as mandated by section 108(b)(4)(A).
>
> We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S Corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable year of discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by section 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1). As such, the Farleys were entitled not only to increase the basis of their S corporation stock but also to take deductions for the Suspended Losses.

Appendix to Petition For Writ of Certiorari ("App.") p. 18a (emphasis in original).

In order to challenge the court of appeal's in-depth analysis, the Government's petition herein presents a fraction of the controlling statutes. Indeed, in reading the Government's petition, one is struck by the conspicuous absence of citations to 26 U.S.C. §§ 108(b)(2)(A), 108(b)(2)(D), 108(b)(4)(A), 108(d)(7)(A), 108(d)(7)(B), all

of which were significant in the court of appeal's analysis of the issue.

REASONS FOR DENYING THE WRIT

In its writ, the Government sets forth that the writ should be granted "[f]or the reasons set forth in the governments brief acquiescing in the petition filed in [*Gitlitz v. Commissioner*, No. 99-1295]" and notes that it has provided the Court with a copy of the brief filed on behalf of the Commissioner in response to the petition for a writ of certiorari in the *Gitlitz* case. Unfortunately, the Government failed to supply us with a copy of its brief in the *Gitlitz* matter when it served its petition herein. Notwithstanding, we can surmise that the Government's position is that there is a conflict among the circuits and there are some outstanding cases which implicate this issue. For the reasons set forth below, it is respectfully submitted that these reasons are insufficient to warrant this Court's review in this case.

The issue presented, which is framed as one of statutory construction, presents little, if any, conflict amongst the circuits over statutory construction. To date, there have been three circuits which have addressed the issue. The Third Circuit in this case; the Tenth Circuit in *Gitlitz*, 182 F.3d 1143 (10th Cir. 1999) and the Seventh Circuit in *Witzel v. Commissioner*, 200 F.3d 496 (2000). All three circuit courts of appeals have uniformly concluded that excluded COD income of an S corporation is an "item of income" within the meaning of 26 U.S.C. § 1366.

Notwithstanding this uniformity, the Government has argued before all three circuits that Congress could not have meant to allow such an excluded item of income to pass through to the shareholders because such a pass through

would amount to a "windfall" in favor to the taxpayers. It is the manner in which the circuits have addressed this policy issue which has caused the circuits to diverge.[1]

In the instant case, the Third Circuit ruled that the plain meaning of the controlling statutes mandated resolving the issue in favor of the taxpayers. In *Gitlitz*, the Tenth Circuit relied primarily upon a timing statute, 26 U.S.C. § 108(b)(4)(A), when it ruled in favor of the Government. The Tenth Circuit apologetically misread that statute suggesting: "that § 108(b)(4)(A) is not an example of legislative clarity" and "[conceding] that, if § 108(b)(4)(A) is read narrowly and in isolation, it is plausible to conclude [in favor of the taxpayer's position]." The Tenth Circuit chose to reform the plain meaning of the statute because: "Taxpayers' interpretation . . . would give taxpayers an unwarranted windfall." Thus, the Tenth Circuit's decision is based on a policy decision adopting the Government's anti-windfall position.

In *Witzel*, the Seventh Circuit expressly rejected the holding of the Tenth Circuit in *Gitlitz*, and expressly supported the taxpayers view that the stockholder's basis was increased, "and this may enable him someday to deduct future suspended losses." Notwithstanding, the Seventh

1. Respondents do not agree that a windfall is created by the statutes as written. Indeed, the Government's position is better described as an attempt by it to preserve a windfall in favor of the Government. Had there been no corporate vehicle, the taxpayers would have used these losses in the ordinary course in prior years. However, in the context of Subchapter S, the Internal Revenue Code requires the tax benefits associated with losses to be suspended if the taxpayer's stock basis is not greater than zero. This creates a windfall in favor of the Government. Not being able to take these losses out of suspense perpetuates the windfall.

Circuit expressly chose not to directly rule on the issue. The Seventh Circuit stated:

> We offer this view [that the shareholder's basis in his stock was increased] tentatively, in part because the Tenth Circuit has held the contrary and we are reluctant to precipitate an intercircuit conflict, in part because Mr. Witzel may never again have suspended losses, making the issue rather moot . . . and in part because a recently promulgated Treasury Regulation (not applicable to this case . . .) adopts the Tax Court's interpretation of section 1366 that we are criticizing.

Thus, the divergent result among the circuits is not due to ambiguity in the statute, but through intellectually questionable activism by the Tenth Circuit, which was expressly rejected by both the Third Circuit and the Seventh Circuit.

As the Third Circuit noted, if there is a windfall in favor of taxpayers, it is not for the judiciary to super-legislate the tax code. The Writ should be denied because the issue presented is one which should only be addressed by Congress.

THIS CASE DOES NOT HAVE FAR-REACHING IMPLICATIONS

A second reason why certiorari should not be granted in this case is that there have been regulatory changes which have already altered the landscape of this issue. As noted by the Seventh Circuit in *Witzel*, the Department of Treasury

has adopted a new regulation, Treas. Reg. § 1.1366-1(a)(2)(viii), 64 Fed. Reg. 71641 (Dec. 22, 1999), effective only to tax years beginning on or after August 18, 1998. This regulation adopts the Government's position that excluded cancellation of indebtedness income does not pass through to stockholders allowing for an increase in the basis in the stockholder's stock.

The new Treasury Regulation will prospectively resolve the issue presented herein, unless and until this new regulation is determined to be invalid. Accordingly, if certiorari is granted, the ruling of this Court will effect a limited number of cases, involving passed tax years. A ruling from this Court will become stale almost instantaneously. It is respectfully submitted that this is not the type of issue where certiorari is warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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